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Supreme Court of the United States

OCTOBER TERM, 1948

No. 285

FIRST STATE BANK OF STRATFORD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT AND BRIEF IN SUPPORT OF PETITION.

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Supreme Court of the United States

OCTOBER TERM, 1948

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FIRST STATE BANK OF STRATFORD,
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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Honorable Fred M. Vinson, Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States

Your petitioner respectfully shows:

SUMMARY STATEMENT OF THE MATTER INVOLVED

This case involves the proper determination of the petitioner's liability for federal income and excess profits taxes for the year, 1942. The sole issue presented is whether this corporation by its distribution of notes as a dividend in kind realized income to the extent of $10,548.20 within the meaning of Section 22 (a) of the Revenue Act of 1938,

c. 289, 52 Stat. 447-584, as amended by Sections 1 and 3 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574. [*26 U. S. C. A. Sec. 22 (a)*.]

On October 17, 1942, the petitioner declared a dividend in kind consisting of notes. The dividend resolution imposed only the obligation to distribute the notes in kind and did not create a cash obligation to be discharged by distribution of the notes. No valuation was placed on the notes either in the dividend resolution or in the findings of fact by the Tax Court of the United States. The basis of the notes distributed had been reduced to zero by deductions for bad debts in prior years. (R. 23-24.)

The notes, with all their rights, were assigned to the stockholders. Although the fact issue was disputed in the Tax Court of the United States, it was established that the petitioner did not retain control over the notes or the amounts collected subsequent to the dividend declaration. (R. 28-29.) Thus the issue for review is confined to the taxable effect of the resolution itself.

After the dividend declaration, collections in the amount of $11,662.71 were effected on the notes. Of the total amount collected, it was determined by the Commissioner of Internal Revenue that $10,548.20 constituted taxable income to the petitioner in 1942 as "recoveries on bad debts or as a profit on the distribution of a dividend in kind." (R. 9.) As a result of this and other uncontested income adjustments, the Commissioner asserted a deficiency of $813.91 in declared value of excess profits tax

and a deficiency of $28,793.28 in excess profits tax against the petitioner for the year, 1942. (R. 7.)

The petitioner filed its petition for redetermination of the deficiencies asserted in the Tax Court of the United States (R. 3-5), to which the respondent answered. (R. 19-21.) The petitioner alleged that the Commissioner erred in taxing to its collections in the amount of $10,548.20. Hearing on the merits was had at Dallas, Texas. (R. 2.) After review by the entire Court, findings of fact and the opinion, to which five judges dissented, were filed. (R. 21-32.) Reversing the determination of the Commissioner, it was held that the petitioner did not realize income by its declaration of property as a dividend in kind and that collections made subsequent to the dividend declaration were not income to the petitioner. (R. 26-30.) Decision was entered pursuant to an agreed computation. (R. 2.) Petition for review by the United States Circuit Court of Appeals for the Fifth Circuit was filed by the respondent. (R. 33-38.)

The United States Circuit Court of Appeals for the Fifth Circuit *en banc* entered its judgment on the 25th day of June, 1948, reversing the decision of the Tax Court of the United States. (R. 91.) The opinion, together with a concurring and two dissenting opinions, was filed on the 25th day of June, 1948. (R. 72-90.) It was held that the distribution of assets with a basis of zero constituted an anticipatory assignment of future income and that collections made subsequent to the dividend declaration were income to the petitioner.

JURISDICTIONAL STATEMENT

The judgment sought to be reviewed is the judgment of the United States Circuit Court of Appeals for the Fifth Circuit rendered on the 25th day of June, 1948 (R. 91), reversing the decision of the Tax Court on a matter involving the determination of income within the meaning of Section 22 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447-584, as amended by Sections 1 and 3 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574. [*26 U. S. C. A. Sec. 22 (a).*]

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. Sec. 347.)

It is urged that this Court exercise its discretion to review because of the importance of the question in the administration of the revenue laws and because of conflict in principle of the decision below with that of decisions by this Court and by other circuit courts of appeals.

The jurisdiction of this Court to review by certiorari a judgment of a circuit court of appeals on the grounds urged was sustained in *Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144.*

QUESTION PRESENTED

Whether, within the meaning of Section 22 (a) of the Internal Revenue Code, the petitioner by its declaration of a dividend in property consisting of notes realized income to the extent of any collections thereafter made by its stockholders.

REASONS RELIED UPON FOR ALLOWANCE OF WRIT

REASON I.

The failure of the Circuit Court of Appeals to apply here the principle that a corporation does not realize income by its declaration of property as a dividend in kind marks the first judicial conflict with this principle since its pronouncement by this Court in *General Utilities and Operating Company v. Helvering, 296 U. S. 200, 56 S. Ct. 185.* The issue has been frequently litigated in the lower courts because of the persistent efforts of the Commissioner to obtain a decision to the contrary.

To reach the conclusion that its decision was not conflicting with the *General Utilities decision,* the Circuit Court had to rule that an asset which does not have a basis in excess of zero is not property or, as therein expressed, a capital asset for income tax purposes. (R. 83-84.) The determination that the notes here were not property violates the fundamental concept in taxation that the status of an asset is not dependent upon the amount of its basis. The decision on that point also conflicts with the principle of decisions in other circuit courts of appeals where non-capital assets without any basis were distributed as a dividend in property, *United States v. Cummins Distilleries Corporation (C. C. A. 6, 1948), 166 F. (2d) 17,* and where notes with a basis of zero were transferred as property for tax purposes in a reorganization, *National Bank of Commerce of Seattle v. Commissioner (C. C. A. 9, 1940), 115 F. (2d) 875.* It is the position of the peti-

tioner that the facts here do not present a case for distinction but a case for application of the *General Utilities decision.*

The basis of many assets may be reduced partially or completely by deductions against income for depreciation, depletion, amortization, worthlessness, and other charges against capital account. Still other assets are acquired without cost. Thus under the rationale of the Court below, the taxable effect of a dividend in many types of property will be dependent on the amount of the basis of the property distributed. A dividend in kind should not occupy the anomalous position in taxation of being an event whereby appreciation in value of property may or may not be realized. Application of the principle announced by the Circuit Court of Appeals will produce unnecessary confusion and untenable results in the administration of the revenue laws.

REASON II.

The decision of the Circuit Court of Appeals that the declaration of the notes here as a dividend in kind constituted an anticipatory assignment of income conflicts with the principles announced by this Court in *Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144,* and *Blair v. Commissioner, 300 U. S. 5, 57 S. Ct. 330.* In those decisions the principle was formulated that a gift of the right to income, as distinguished from a gift of all interests in property, was in itself realization of that income.

The Circuit Court of Appeals held that under the doctrine of the *Horst case* the declaration of a dividend in

kind is in itself realization of income. By so ruling, the Court transcended the doctrine of that case. The *Horst case* recognizes a gift as a method by which income may be realized. To hold that a dividend in kind is a method by which income may be realized is to establish a new principle in taxation. Whether under the revenue laws realization of income may occur through distribution of property to its equitable owners is an issue for determination of this Court.

By holding that the assignment of property with a basis of zero is an anticipatory assignment of income, the Circuit Court of Appeals ignored the fundamental distinction drawn by the above cases between assignments of all interests in property and a mere right to income. If all interests in appreciated property are assigned, as here, the basis of that property is immaterial under those cases. To hold that assignment of appreciated property with any basis constitutes an anticipatory assignment of income presents a fundamental issue for the determination of this Court.

To adopt the concept of realization of income of the Court below would produce inequitable results and confusion in the administration of the revenue laws.

WHEREFORE, your petitioner prays that a writ of certiorari issue under the seal of this Court, directed to the United States Circuit Court of Appeals for the Fifth Circuit, commanding said Court to certify and send to this Court a full and complete transcript of the record and of the proceedings of the said Circuit Court had in the case

numbered and entitled on its docket, *No. 12,183, Commissioner of Internal Revenue, Petitioner v. First State Bank of Stratford, Respondent,* to the end that this cause may be reviewed and determined by this Court as provided for by the statutes of the United States; and that the judgment herein of said Circuit Court be reversed by the Court, and for such further relief as to this Court may seem proper.

Respectfully submitted,

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Supreme Court of the United States

OCTOBER TERM, 1948

No......

FIRST STATE BANK OF STRATFORD,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

OPINIONS OF THE COURTS BELOW

The opinion of the Tax Court of the United States is reported in 8 T. C. 831 and appears at Pages 21-32 of the Record. The opinion of the United States Circuit Court of Appeals for the Fifth Circuit, rendered on June 25, 1948, has not been officially reported to date but the opinion in full appears at Pages 72-90 of the Record.

JURISDICTION

The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229, Section 1, 43 Stat. 938 (28 U. S. C. A. Sec. 347.)

The judgment sought to be reviewed is that of the United States Circuit Court of Appeals for the Fifth Circuit rendered on the 25th day of June, 1948 (R. 91), reversing the decision of the Tax Court of the United States on a matter involving the determination of income within the meaning of Section 22 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447-584, as amended by Sections 1 and 3 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574. [26 U. S. C. A. Sec. 22 (a).]

It is urged that this Court exercise its discretion to review because of the importance of the question in the administration of the revenue laws and because of conflict in principle of the decision below with that of decisions by this Court and by other circuit courts of appeals.

The jurisdiction of this Court to review by certiorari a judgment of a circuit court of appeals on the grounds urged was sustained in *Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144.*

STATEMENT OF THE CASE

This has been stated in the preceding petition under the heading "Summary Statement of the Matter Involved," which is hereby adopted and made a part of this brief.

ERRORS RELIED UPON

I.

The United States Circuit Court of Appeals for the Fifth Circuit erred in failing to apply to the facts here

the doctrine announced by this Court that a corporation does not realize income by its distribution of appreciated property as a dividend in kind.

II.

The United States Circuit Court of Appeals for the Fifth Circuit erred in holding that the petitioner effected an anticipatory assignment of income thereafter received by its stockholders, for the reason its holding improperly interprets Section 22 (a) of the Internal Revenue Code and is contrary to authority.

SUMMARY OF ARGUMENT

The petitioner by its declaration of notes as a dividend in kind did not realize income within the meaning of Section 22 (a) of the Internal Revenue Code. This case requires the application of the principle that a corporation does not realize income by its declaration of property as a dividend in kind. The application of the doctrine of anticipatory assignment of income to this case is improper and conflicts with authority.

ARGUMENT

The petitioner by its declaration of notes as a dividend in kind did not realize income within the meaning of Section 22 (a) of the Internal Revenue Code.

I. This case requires application of the principle that a corporation does not realize income by its declaration of property as a dividend in kind.

Here the dividend resolution imposed only the obligation to distribute the notes as a dividend in kind. After the dividend declaration, the petitioner did not exercise control over the notes or collection made. (R. 29.) Having accepted these facts for the purpose of its review, the Circuit Court of Appeals should have held that the petitioner did not realize income by its distribution of notes as a dividend in kind in accordance with the principle announced in *General Utilities and Operating Company v. Helvering, 296 U. S. 200, 56 S. Ct. 185.*

Here the notes had appreciated in value above a basis of zero, but their value was difficult to determine. (R. 25.) In the *General Utilities case*, the stock had appreciated more than a million dollars above its basis of two thousand dollars. In either case, the amount by which the property had appreciated over its basis represented potential income which had not been realized under any theory of accounting by the distributing corporation. Thus, as recognized by the Tax Court, the question in both cases is whether potential income was realized through the distribution of the appreciated property as a dividend in kind.

To distinguish its decision from that in the *General Utilities case*, the Circuit Court of Appeals held that the rule of that case is applicable only to distributions of capital assets. (R. 83-84.) No other Court interpreting the rule of the *General Utilities case* has inquired into the status of the property distributed or its basis. The courts have repeatedly stressed that the determination of the fact issue as to whether a dividend was declared in kind is

decisive of the question whether the corporation realized income by its distribution, *Commissioner v. Columbia Pacific Company (C. C. A. 9, 1935), 77 F. (2d) 759; Transport, Trading & Terminal Corporation, 9 T. C. 247; Horne Oil Company, T. C. Memo. Dkt. No. 10286; Beach Petroleum Corporation, Ltd., T. C. Memo. Dkt. No. 3273; J. L. Washburn Estate, Inc., T. C. Memo. Dkt. No. 1240, appeal dismissed (C. C. A. 8, 1945), 151 F. (2d) 1016; Herbert G. Hanan, T. C. Memo. Dkt. No. 1539, appeal dismissed (C. C. A. 2 and 3, 1945).*

To support its distinction between this case and the *General Utilities case*, the Circuit Court held that assets with a basis of zero do not constitute capital assets for income tax purposes. (R. 83-84.) The concept that the status of property as a capital asset depends upon the amount of its basis conflicts with the statutory definition of a capital asset contained in Section 117 (a) (1) of the Internal Revenue Code [26 U. S. C. A. Sec. 117 (a) (1).] Under the statutory definition, the notes here were capital assets to the same extent as the stock in the *General Utilities case*. Because deductions for worthlessness chargeable against capital account have been taken against current income, property does not lose its status or transferability as a capital asset, *Avery R. Schiller v. Commissioner, 43 B. T. A. 594, 597-8; I. T. 3121, 1937-2 C. B. 138, 139.* To hold otherwise is to engage in judicial legislation.

By its distinction between capital assets and non-capital assets, the Circuit Court probably meant to imply that the notes here were not property for income tax purposes.

(R. 77-78.) Its decision on this point conflicts with the case cited as authority, *National Bank of Commerce of Seattle v. Commissioner (C. C. A. 9, 1940), 115 F. (2d) 875.* There charged-off notes were transferred to another bank in a reorganization. Although loosely referred to as non-capital assets in the hands of the transferors, the Court apparently meant to imply only that the notes had a basis of zero. It was held that since the notes had a basis of zero to the transferors, their basis was zero to the transferee to whom subsequent collections were taxed. If the notes were not regarded as property, there would have been no reason to determine their basis in the hands of the transferors. It is never necessary to determine the basis of income as distinguished from property.

It is submitted that the decision of the Circuit Court also conflicts with the recent decision of the Sixth Circuit Court of Appeals in *United States v. Cummins Distilleries Corporation (C. C. A. 6, 1948), 166 F. (2d) 17.* There warehouse receipts for whiskey were distributed as a dividend in kind in liquidation to stockholders who held them jointly, as were the notes here. The amounts expended in production of the whiskey did not represent capital investments under any theory of accounting, and the whiskey or the warehouse receipts did not represent capital assets under the statutory definition. No other court has ever suggested that there is a distinction in the type of property which may be transferred as an ordinary dividend in kind and as a dividend in kind in partial or complete liquidation. The Circuit Court apparently recognized that property with a basis of zero could be effectively transferred as a dividend

in kind upon liquidation. (R. 77-78.) Logically, there should be no distinction in the tax effect or type of property subject to transfer as a dividend in kind, whether or not it is made in liquidation, *First Savings Bank of Ogden v. Burnet (App. D. C., 1931), 53 F. (2d) 919, 921.*

The rationale of the Circuit Court requires that the taxable effect of any dividend in kind be dependent on the basis of the property distributed. Whether the basis of the property had been reduced by depletion, depreciation, amortization, worthlessness, or any other charge against capital account, the reasoning of the Circuit Court would be equally applicable. A corporation would be deemed to have made an anticipatory assignment of income by distribution of oil property, the basis of which had been recovered by depletion, cf. *Horne Oil Company supra; Beach Petroleum Corporation, Ltd., supra.* By reason of the distribution in kind of property with an appreciated value of one thousand dollars and with a zero basis, income would be realized; but if property with an appreciated value of one thousand dollars and with an unreduced basis of ten dollars were distributed in kind, income would not be realized. The exact result which might attend application of the Court's decision to assets with a partially reduced basis is a matter for conjecture. To hold that the basis of property determines whether any event is an occasion for realization of income is to violate the fundamental concepts of taxation and to cause unnecessary confusion in the administration of the revenue laws.

Since the distinction asserted between the facts of the two cases is insupportable, the decision of the Circuit Court

of Appeals is in direct conflict with that of this Court in *General Utilities and Operating Company v. Helvering, supra.*

II. The application of the doctrine of anticipatory assignment of income to this case is improper and conflicts with authority.

The decision of the Circuit Court of Appeals that the declaration of the notes here as a dividend in kind constituted an anticipatory assignment of income conflicts and involves an improper application of the principles announced by this Court in *Helvering v. Horst, 311 U. S. 112, 61 S. Ct. 144,* and *Blair v. Commissioner, 300 U. S. 5, 57 S. Ct. 330.*

In *Blair v. Commissioner, supra,* it was held by this Court that the assignment as a gift of a right to trust income was not an anticipatory assignment of income. The donor was deemed to have effected an assignment of property consisting of his equitable interest in the trust principal together with his rights to the trust income. In *Helvering v. Horst, supra,* it was held that the assignment as a gift of an interest coupon which had been severed from the bond was in itself realization of income by the donor. The donor by his gift had assigned only a right to income and had retained his interest in the capital.

Here the notes, together with all their rights, were assigned to the stockholders through the medium of a dividend in kind. The petitioner did not satisfy any donative impulse by the delivery of property to its equitable owners.

The notes did not represent income to the petitioner at the time of the transfer under any theory of accounting.

The Circuit Court of Appeals held that the assignment of appreciated property with a basis of zero is an anticipatory assignment of income. (R. 77-78.) By its decision, the Court discarded the fundamental distinction drawn by the above cases between assignment of all interests in property and a mere right to income. Under the rationale of the Court, it would be necessary to ascertain only the basis of property to determine whether an anticipatory assignment of income had been made. Even in the field of gifts, the principle of the above cases never has been extended to distributions of appreciated property. Whether the assignment of appreciated property with a zero basis or any other basis is an anticipatory assignment of income presents a fundamental issue for the determination of this Court.

The Circuit Court of Appeals relied upon the *Horst case* as authority that the declaration of a dividend in kind is in itself realization of income thereafter collected by stockholders. By its ruling, the Court did not follow the principle of the *Horst case;* it evolved an entirely new concept of realization of income. The *Horst case* recognizes a gift as a method by which income may be realized. Whether under the revenue laws a dividend in kind may be added to the methods of realization is a fundamental issue for determination by this Court.

Even assuming its constitutionality, there would appear to be no justification for extending the concept of realiza-

tion of income to assignments of appreciated property. Both in the fields of gifts and dividends in kind, the appreciation in value of the property assigned does not escape taxation. A donee holds appreciated property at the same basis as his donor. When the donee sells the property, any income thus realized is taxable to the donee. Property which is declared as a dividend in kind must be reported by stockholders upon receipt as income to the full extent of its market value. (R. 84-85.) Any amounts which the stockholders subsequently collect over the fair market value of the notes are also taxable to them. Thus there is no justification for application of the doctrine of anticipatory assignment of income to assignments of appreciated property, either as a dividend in kind or as a gift.

CONCLUSION

An unnecessary and confusing situation is created in the administration of the revenue laws by the decision of the Circuit Court of Appeals that the distribution of property with a zero basis is an anticipatory assignment of income. The decision of the Circuit Court transcends all previous authority and evolves a new principle of taxation which cannot be justified or supported by authority.

The refusal of the Circuit Court to hold that income is not realized through the distribution of a dividend in kind, however measured, is in direct conflict with the principle of this Court announced in *General Utilities and Operating Company v. Helvering, supra.* For the uniformity which has attended the acceptance of that principle, the Circuit Court has substituted diversity and confusion.

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers, by granting a writ of certiorari and thereafter reviewing and reversing said decision.

Respectfully submitted

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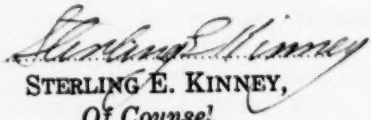

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APPENDIX

Statutes

Section 22 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447-584, as amended by Sections 1 and 3 of the Public Salary Tax Act of 1939, c. 59, 53 Stat. 574 [26 U. S. C. A. Sec. 22 (a)] provides:

> "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

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In the Supreme Court of the United States

OCTOBER TERM, 1948

No. 285

FIRST STATE BANK OF STRATFORD, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 21-32) are reported at 8 T. C. 831. The opinion of the Court of Appeals (R. 71-85) is reported at 168 F. 2d 1004.

JURISDICTION

The judgment of the Court of Appeals was entered on June 25, 1948. (R. 86.) The petition for a writ of certiorari was filed September 17, 1948. The jurisdiction of this Court rests upon 28 U. S. C. 1254.

QUESTION PRESENTED

After collections were begun and expected on notes on which petitioner had in prior years taken deductions for bad debts, petitioner declared a dividend of the notes. The question is whether $10,548.20 of the amount collected on the notes in the remaining two and a half months of the taxable year, representing the amount of the collections on which petitioner had received a tax benefit and which therefore would have been income to petitioner had it retained the notes, is taxable to petitioner as anticipatorily assigned income.

STATUTE INVOLVED

Internal Revenue Code:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income * * *, of whatever kind and in whatever form paid, * * * derived from any source whatever. * * * [26 U. S. C. 22]

STATEMENT

The facts as found by the Tax Court are as follows:

Petitioner is a corporation, organized under the law of Texas, and engaged in the business of banking at Stratford, Texas. It has outstanding 500 shares of stock. On October 17, 1942, the bank had 9 stockholders, of whom 5 were directors. Three of the directors worked in the bank. (R. 22.)

On October 17, 1942, at a regular monthly meet-

ing of the board of directors, all directors (L. M. Price, A. E. Pronger, P. J. Pronger, U. N. Price, and Hose Flores) being present, a dividend in kind was declared, consisting of notes which had been charged off as worthless and deducted as bad debts in income tax returns in earlier years. These notes had been charged out of assets and did not appear on the bank's books. They had been kept in a case by themselves. They were brought to the directors' meeting and the possibility of their collection discussed. About $25,000 had previously been collected on the notes included in the dividend, and on some of the notes included in the dividend payments were then being currently made. (R. 22-23.) The minutes of the action taken by the directors read (R. 23-24):

> The following recoveries were read and discussed by the directors:
>
> | | |
> |---|---|
> | Troy Plunk ..... | $5.00 |
> | E. O. Palmer ..... | 15.00 |
> | Arthur Cartrite..... | 1,200.00 |
> | Dortha S. Daniels..... | 4.00 |
> | J. L. Turner ..... | 8.00 |
> | Dortha S. Daniels..... | 4.00 |
>
> The payment of a dividend by the bank was next considered. Attention was called, however, to the matter of increased income and excess profits taxes and the advisability of deferring the payment of a cash dividend until later in the year when more would be known about the new Income Tax Law about to be

enacted in Congress. It was pointed out that the bank had a number of charged off accounts of doubtful value, also real estate carried on the books at a nominal sum of $1.00. Advisability of paying a dividend of a portion or all of these properties was discussed and fully considered. Upon motion duly made and seconded, the following resolution was adopted:

Whereas, This bank is the owner of several thousand dollars of charged off notes, some of which may be collected in future, and the balance of which are of doubtful value.

Now, Therefore, Be it resolved that the following charged off notes be assigned to the stockholders of this bank without recourse on it, said notes being paid as a dividend in kind and without any value being placed thereon by this bank.

Then follows a listing of the notes included in the dividend. No valuation was placed on the notes by the resolution. The bank's officers hoped that the majority of the notes would be collected, but their value was difficult to determine. Notes of about $160,000 to $170,000 (the amounts unpaid thereon) were examined as to collectibility, of which about $57,000 were considered notes with remote chance of collection, and the notes were listed in the dividend resolution with an amount set opposite each, totaling $111,254.38, as to all. These included the following notes (R. 24):

Troy Plunk	$32.29
E. O. Palmer	1,101.54

Arthur Cartrite	4,664.35
Dorothy S. Daniels	82.00
J. L. Turner	676.56
H. B. Ritchie	75.00
H. B. Ritchie	5,103.07

Notes considered completely uncollectible were not included in the dividend. (R. 24.)

After the directors' meeting, the directors, as stockholders, further discussed the matter. L. M. Price suggested, with the approval of P. J. Pronger, that W. N. Price take charge for the stockholders of the notes which had been included in the dividend. The matter was discussed and the notes included in the dividend were endorsed, within the next few days, to W. N. Price, as follows: "Pay to the order of W. N. Price, Special, without recourse, First State Bank of Stratford, by Hose Flores, Assistant Cashier." Amounts thereafter collected in 1942 on the dividend notes were deposited in the bank in an account designated, "W. N. Price, Special." W. N. Price, in attempting collection of the dividend notes, did nothing special that he did not do in collecting notes owed to the bank. At various times he worked after banking hours collecting the dividend notes. No system of bookkeeping for the dividend notes was set up by the stockholders in 1942. (R. 24-25.)

On November 15, 1942, the board of directors held a meeting, at which they discussed recoveries as follows: J. L. Turner, $8; H. B. Ritchey, $40;

and a loss on H. B. Ritchey loan, $75. H. B. Ritchey had two notes, one of $75 and one of $5,103.07; J. L. Turner, one of $676.56. The $40 collection from H. B. Ritchey and $8 from J. L. Turner were deposited in the W. N. Price special account on December 19, 1942. (R. 25.)

From October 17, 1942, to December 31, 1942, collections of $11,662.71 were made on the dividend notes. The record does not indicate what part is interest, or principal. No report as to collections on the dividend notes was made to the directors by W. N. Price. On several occasions he reported the amounts collected to the stockholders, by telephone or personally. The debtors were not notified of the assignment of their debts to the stockholders. The notes when paid were stamped "Paid" with a stamp on which appeared the bank's name, but not the stockholders' committee. The stockholders could withdraw such collections from the W. N. Price special account; they were not available to the bank. Between 60 and 70 per cent of the dividend notes have been collected. (R. 25.)

The first distribution to stockholders of money collected was in November 1943. This was decided on by the stockholders who were directors, not by all of the stockholders. There was no particular reason for delay. The stockholders did not particularly need the money. They did not demand the money in 1942. W. N. Price did not report any of the collections for taxation in 1942. (R. 25-26.)

The Commissioner determined that $10,548.20 of the $11,662.71 collected on the notes in 1942 was taxable income to the bank. (R. 26.) The Tax Court, with five judges dissenting, held that the recoveries on the notes were not income to the bank. (R. 26-32.) Sitting *en banc*, the Court of Appeals reversed the decision of the Tax Court, two judges dissenting. (R. 71-85.)

ARGUMENT

The reasons advanced by petitioner for further review of the case by this Court consist of assertions that the decision below is in conflict in principle with certain decisions of this Court and of the Courts of Appeals. Pet. 5-7.) Actually, the asserted conflict is not only non-existent but the decision below is supported by decisions of this Court.

The alleged conflict with *General Utilities Co.* v. *Helvering*, 296 U. S. 200, is premised upon two unwarranted assumptions—(1) that the *General Utilities* decision stands for the broad proposition that a corporation does not realize income by the declaration of a dividend in kind of anything that may be termed "property" (See Pet. 5; Br. 11-12, 15-16), and (2) that the court below held that a corporation does reali e income by the distribution as a dividend in kind of any type of property having a zero basis (See Pet. 5-6; Br. 13, 15). In the *General Utilities* case the Court simply held that the taxpayer-corporation did not realize taxable gain in the amount of the appreciation in value of

stock of another corporation distributed as a dividend in kind, there being no sale or use of the stock to discharge indebtedness. In the present case the court below held the *General Utilities* decision inapplicable because of the difference in the nature of the property involved in the two cases. It is plainly evident from the opinion that the result reached was directly attributable to the indisputable fact that, since the notes represented income to petitioner, the dividend assignment of the notes was merely an assignment of petitioner's right to collect income.[1] The *General Utilities* decision was distinguished on the ground that the stock there involved was a capital asset, meaning that "the fruit was on the tree", whereas the notes in the instant case represented *income* in that "the tree itself represents fruit of prior years that was not taxed."[2] (R. 80.) Thus, petitioner is in

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[1] As contrasted with stock or any other property as to which the potential income is represented by an appreciation in value, the realization of income by petitioner from these notes was not dependent upon a sale or other disposition. The bank would have realized income in the amount of the collections on the notes involved here had it retained the notes, for to that extent the notes represented previously charged-off debts on which petitioner had received a tax benefit. It is well settled, and petitioner does not dispute the fact, that, as the court below stated (R. 75), when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year.

[2] There is no necessary relevance or merit in petitioner's statements (Br. 13) regarding the statutory definition of capital assets under Section 117(a)(1) of the Internal Revenue Code (26 U.S.C. 117). Under that section "capital assets"

error in stating (Br. 15) that the rationale of the decision below would make the effect of any dividend in kind depend upon the basis of the property distributed and that the decision would apply whether the basis of property had been reduced by depletion, depreciation, amortization, worthlessness, or any other charge against capital account. Since the decision below is limited in its applicability to property which itself represents income in that no sale or other disposition is necessary to the realization of income from it, the decision is not

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mean "property" with the exception of certain classes not involved here. The court below held that the dividend notes were "property", for it stated (R. 78) that the notes were assets of the bank and "subject to transfer as other property," but the fact that the notes were property does not mean that they were capital assets. The sense in which the court below used the term "capital assets" would seem to be a proper one (see definition of "capital", Webster's New International Dictionary (2d ed., 1939), p. 397) but in any event petitioner is not aided by its reliance upon Section 117(a)(1). In the first place, Section 117 merely operates to reduce the amount of gain taxed and loss allowed on the sale or exchange of types of property not excluded from the definition of capital assets, and, since no sale or exchange was involved here, the section is not controlling. Secondly, the fact that these notes were "property" and would come within the literal language of Section 117(a)(1) does not *per se* make them capital assets under that section, for even on a sale or exchange of property which merely represents the right to receive income such property is not considered a capital asset; instead, effect is given, as under the anticipatory assignment of income rule, to what the property represents, not the fact that it is property, and the sale price is considered a commuted substitute for the income the vendor would otherwise have received from the property. See *Hort* v. *Commissioner*, 313 U.S. 28; *Rhodes' Estate* v. *Commissioner*, 131 F. 2d 50 (C.C.A. 6th); *Helvering* v. *Smith*, 90 F. 2d 590, 592 (C.C.A. 2d). This also answers petitioner's statement (Br. 13) that "Under the statutory definition, the notes here were capital assets to the same extent as the stock in the *General Utilities case.*"

applicable, for example, to property subject to depreciation, from which no income could be realized in the absence of a sale or other disposition regardless of its basis.

When the decision below is viewed in the light of what it holds rather than according to petitioner's interpretation of it, the decision is not in conflict with this Court's decision in the *General Utilities* case. That decision not only did not purport to hold that income cannot be realized by a dividend assignment of the type of property involved here but this Court has held time and again that a person vested with the right to receive income does not escape the tax on it by any kind of anticipatory arrangement whereby the income is paid to another. *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122; *Harrison* v. *Schaffner,* 312 U. S. 579; *Douglas* v. *Willcuts,* 296 U. S. 1; *Burnet* v. *Leininger,* 285 U. S. 136; *Lucas* v. *Earl,* 281 U. S. 111; *Commissioner* v. *Tower,* 327 U. S. 280; *Commissioner* v. *Harmon,* 323 U. S. 44; *Commissioner* v. *Sunnen,* 333 U. S. 591. Moreover, this rule was applied in *United States* v. *Joliet & Chicago R. Co.,* 315 U. S. 44, to a dividend arrangement. All of these cases involved an assignment of at least a right to receive income, which may be regarded as "property", and the *Horst* case, in which the anticipatory assignment of income rule was explained at length, involved the assignment of an interest coupon. These decisions require that

effect be given to what the property represents, not the fact that it is property, and it is the recognition of that very requirement on which the decision below is based.

Petitioner's assertions (Pet. 5; Br. 14-16) that the decision below conflicts in principle with *United States* v. *Cummins Distilleries Corp.*, 166 F. 2d 17 (C. C. A. 6th), and *National Bank of Commerce* v. *Commissioner*, 115 F. 2d 875 (C. C. A. 9th), also result from petitioner's failure to apprehend the true basis of the decision below. *United States* v. *Cummins Distilleries Corp., supra*, involved a dividend distribution of whisky, which is of the same type of property *as the stock involved in the General Utilities* case and is not covered by the decision below. *National Bank of Commerce* v. *Commissioner, supra*, involved the transfer of charged-off notes in a reorganization. The case seems to be relied upon by petitioner for the fact that the notes there involved were considered property and capital assets to the *transferees*. (See Pet. 5; Br. 14.) That the decision is not in conflict with the decision below is evident from the fact that the court below relied upon the decision, which also stated that to the *transferors* the notes represented income, not capital. (R. 75.)

Nor is petitioner correct in asserting (Pet. 6-7; Br. 16-17) that the decision below conflicts with *Helvering* v. *Horst, supra*, and *Blair* v. *Commissioner*, 300 U.S. 5, by discarding the fundamental

distinction drawn in those cases between an assignment of all interests in property and of a mere right to income. That distinction was as to income which had not yet been earned and had not accrued at the time of the assignment, and the cases are applications of the Court's holding in *Lucas* v. *Earl,* 281 U.S. 111, that income, the "fruit", is attributable to the "tree" on which it grows. Thus, in the *Horst* case, where a father transferred an interest coupon to his son as a gift, it was held that the father was taxable on the interest subsequently received by the son because the father had retained the bond which produced the interest. In the *Blair* case, on the other hand, it was held that the gift was of the income-producing property, consisting of an interest in a trust, and, as the Court later stated in the *Horst* case (311 U.S. at 119), the subsequently earned trust income was regarded as no more the income of the donor than would be a crop raised on a farm after the farm had been given away. The question whether the "tree" or just income has been assigned is of no importance when the income has been earned prior to the assignment, for the income remains attributable to the owner of the "tree" at the time the income was earned. *Austin* v. *Commissioner,* 161 F. 2d 666 (C.C.A. 6th); *Anthony's Estate* v. *Commissioner,* 155 F. 2d 980 (C.C.A. 10th). Similarly, in the present case, where the notes themselves represented income prior to their assignment as a

dividend and the dividend assignment was of petitioner's right to receive that income, the distinction drawn as between the *Horst* and *Blair* cases with respect to the source of the income is inapplicable. See *Richards' Estate* v. *Commissioner,* 150 F. 2d 837 (C.C.A. 2d); *Doyle* v. *Commissioner,* 147 F. 2d 769 (C.C.A. 4th).

Petitioner's statement that the decision below transcends the doctrine of the *Horst* case in holding the anticipatory assignment of income doctrine applicable to a dividend assignment (Pet. 6-7; Br. 17) is answered by the fact that in *United States* v. *Joliet & Chicago R. Co., supra,* this Court applied the doctrine to a dividend arrangement.

CONCLUSION

The decision below is correct and involves no conflict of decisions. The petition for a writ of certiorari should therefore be denied.

Respectfully submitted,

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